MANUFACTURERS HANOVER

Economic Report

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Commentary on Pertinent Economic Issues

We Never Promised A Rose Garden

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Pity those economists who sit at their screens all day, scrutinizing the minute-by-minute minutia of the financial markets. They tend to immerse themselves so much in the ebb and flow of the data that they literally are unable to see the forest for the trees. Some of them work for bond houses; they seemingly never met a statistic they liked. For you see, bearish economic numbers tend to lift bond prices since they imply lower interest rates, and these economists in particular must feel a need to help their firms sell bonds.

If this were not enough, consider the industry most economists work in, and the region in which they are located. I'm referring to the financial services industry and the Northeast—both of which have been hit harder than usual during the recent recession. But there is life west and south of the Pennsylvania border. Indeed, conditions in the Northeast notwithstanding, there is persuasive evidence of a slow but steady economic recovery building up. Let me bring you up to date:

- Business sales are now up for four straight months, the first such increase since 1989;
- Business inventories are now at a two-year low, having fallen for six straight months, the longest such period in 8½ years;
- Industrial production has climbed for five months in a row, the first time that's happened in a year;
- The Purchasing Managers' Index of conditions in the industrial sector has climbed every month since January, and now stands at a three-year high;
- New-home construction, in the form of housing starts, has gone up for five straight months, the first time that's happened since 1980;
- The Government's index of leading economic indicators has risen for six straight months—the most in four years;
- Business payrolls have expanded by 110,000 in the past four months, compared with a drop in 885,000 during the previous four;
- More than half of all reporting industries are now adding to their payrolls—the most since just before the recession began last year—while the weekly number of new claimants for jobless benefits has dropped by over 140,000 from their March peak.

Services Slim Down

These gains in employment may come as a surprise to many who work in financial services in the Northeast. And with good reason: 14 months after total employment reached a peak, jobs in what the Labor Department calls F.I.R.E. (Finance, Insurance and Real Estate) are down 0.7 percent. By contrast, employment in this category continued to grow during the same period surrounding all eight previous postwar recessions. Needless to say, the Northeast has a disproportionate number of workers in the financial services industry.

Other service categories have also been hard hit. Government employment, for one, has fallen 1.2 percent during the past 14 months—the second largest decline for this point in the business cycle, and only the third such drop during the entire postwar era. Total service payrolls are down 0.4 percent, the most since the 0.6 percent drop recorded during the period surrounding the 1957-58 recession. Further cuts are in store, according to a recent survey by the American Management Association, which also reports that corporate downsizing ran at a record pace during the past year.

To compound matters, many of those who have lost their jobs may be unable to obtain employment in their fields. The Labor Department believes this is most likely to happen to people who are laid off by the Federal government, and by companies in financial services. As a result, many will have to settle for jobs paying less than the ones they lost. This may account for the growing incidence of part-time employment, as people take on a second job in order to bolster their incomes. In addition, the long-run trend towards multiple-worker households continues unabated.

Although these displaced workers might not agree, there are several bright spots in this otherwise gloomy service sector picture. First, fewer workers can result in greater productivity.

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Service industries have been lagging in this regard—even though such innovations as personal computers, word processors, desk-top publishing with laser-jet printing, fax machines and new telecommunications systems have become commonplace. In turn, this will help keep labor costs down—especially important in this labor-intensive sector. Corporate profitability will benefit from this—and this is also important in today's environment, where making a sale can be tough and boosting prices can be even harder. And, of course, this means that the progress made in slowing inflation will continue. Less inflation will help keep interest rates down, thereby ensuring that the nascent recovery will not come to an untimely end.

Since four-fifths of the workforce is in the service sector, this murky job outlook has understandably depressed the attitudes and buying plans of a great many families. The Northeast's nabobs of negativism point to this, along with negligible income growth, a low savings rate and record debt loads as reasons not to expect much help from the consumer in the coming months. And if consumer spending, which, as everyone must know by now, accounts for two-thirds of the gross national product, fails to rise, the ripple effects on the rest of the economy would be hard to overcome and a new (or continuation of the old) recession would occur.

Goods Growth Gives A Lift

Not to worry! The gloomsters are overlooking one crucial development—the ongoing improvement in the goods-producing sector of the economy. As noted earlier, industrial production is in an unmistakable uptrend. As also pointed out, this is not being accompanied by an increase in unsold goods. Indeed, quite the opposite is taking place: the five-month rise in production has accompanied a six-month drop in inventories! To put in bluntly, producers are not increasing output with the intent of adding to their stockpiles. Rather, they are trying to keep them from being depleted too rapidly.

A couple of conclusions can be drawn at this point. First, manufacturing is as important to the economy today as it's ever been since the end of World War II, so developments in this sector still carry a lot of weight. Second, the ongoing rise in industrial production means factor incomes have gone up as well. In other words—someone has to be making more money, given the rise in output, whether it is the workers who run the assembly lines, their employers or their vendors. Let's not forget those companies that provide the fuels, electricity, machinery and equipment. These firms all pay taxes, so governments at all levels are taking in more money as well.

It doesn't take a rocket scientist to figure out that even at this stage, more money is being earned and/or made available for spending. At some point, these expenditures will necessitate an increase in inventories, since it is awfully hard to sell products that don't exist. As pointed out earlier, business sales have already climbed for four straight months; it is only a matter of time before many companies conclude that more—not less—inventories are needed. For if there's one thing worse than losing sales for lack of buyers, it's losing sales for lack of merchandise.

Before this past recession began, many economists argued that better methods of inventory control would modify—if not prevent—the next recession. They pointed to widespread use of computers and the so-called "just in time" system of inventory management popular in Japan. However, it would appear as though business trimmed its inventories by about as much in this past recession as it did, on average, in previous downturns. This is because relatively few firms actually use the "just in time" method as it is practiced in Japan, since they have not built up the comprehensive network of arrangements with suppliers, shippers, etc., necessary to make this work. In many cases, firms claiming low inventories have either shifted the burden to their suppliers, or to their customers through discounts and other incentives. Thus, when sales get to the point where more inventories are necessary, there could be a rush to rebuild.

In any event, the gains in output have already boosted incomes of factory employees, by enabling them to work longer hours and find more jobs. Surely, this has led to increases in spending by consumers in some parts of the country; retail sales in the Midwest are up 2½ percent compared with a decline of 1½ percent in the rest of the country. It is only a matter of time before they bottom out elsewhere since some service sector hiring will be needed just to keep pace with the rise in goods output and sales.

Also required for economic growth are lower interest rates and more money in circulation. That rates have come down cannot be denied. Over the past two years, the key Federal funds rate has fallen 4½ percentage points, leading to

declines in other short-term rates—including bank lending rates to business, as well as rates consumers pay on home equity loans and other loans whose rates are tied to short-term rates. However, it would seem that these lower rates have done little to spur increased borrowing by either consumers or business, since both consumer credit and business loans outstanding have been shrinking for most of this year. This, of course, implies less spending.

Pushing On A String?

As for the money supply, the widely-followed M2 version has fallen $11.6 billion over the past three months. This has brought its year-to-date growth rate close to the Federal Reserve's minimum objective. Thus a number of observers—including many who would otherwise have an optimistic view on the outlook—have expressed concern not only over the ability of the economy to grow, but also because the Fed seems to be "pushing on a string."

These anxieties are not unfounded. Huge debt loads are keeping many consumers and businessmen from borrowing, while lender caution and regulatory constraints are limiting the amount of funds available. To this must be added the fact that households earn twice as much interest income as they pay in interest expense, and the proportion of personal income derived from interest stands at a near record.

Here, too, all is not bleak. For one thing, with $626 billion of commercial and industrial loans outstanding, lower rates mean lower interest payments for business of as much as $12½ billion, or nearly eight percent of after-tax profits. This frees up a lot of money for spending on new employees, machinery and equipment, and research and development. No matter how much is allocated to each, the net result is more incomes, hence more spending power in the economy. For their part, consumers with adjustable rate mortgages and other loans will find themselves in similar circumstances; more money left to spend (or save) as desired. Those holding bonds as investments must also feel better, since lower rates mean higher bond prices. And for those inclined to buy a home, lower rates obviously make such a purchase more affordable.

The money supply's meager growth is not as problematic as it appears, nor does it necessarily suggest an impotent Fed. The Fed never could directly control the money supply—especially at this stage of the cycle, when it would be seeking to pump it up. This is because the Fed can only directly control its own balance sheet, what some would refer to as the monetary base. The Fed has increased the bank reserves portion of the monetary base quite substantially in recent months. Indeed, the 12-month rise in total bank reserves is now the greatest in four years. But this has not translated directly into M2 money growth for two reasons: (1) Less bank lending, and (2) a flow of funds out of small certificates of deposit.

Let us examine each in detail. As is well known by now, businesses have been borrowing less from their banks. From a high of $648 billion at the end of last year, commercial and industrial loans have fallen $22 billion, or about 3½ percent. Some of this is due to greater lender caution, since this period encompasses most of the past recession. Some also traces to regulatory constraints, such as tightened examination and capital standards. But some can also be attributed to less demand from business since inventories are down. Also, many companies are replacing short-term debt with funds raised in the bond market, now that long-term interest rates have come down as well.

To the extent that some banks have excess reserves, however, they are not lying idle. They are either lent temporarily to those banks who need them, or are invested in U.S. Government obligations. Either way, they remain in the economy, available to be converted into spending. The same is true for the funds that have left the banking system's small-denomination time deposits looking for higher yields elsewhere. They have gone into mutual funds that invest in such higher-yielding instruments as Treasury notes and bonds, "Ginny Maes", corporate bonds and the like. They may not count as M2 money—but they are in the economy just the same.

The current recovery, like the recession that preceded it, has many unusual aspects. As such, like the recession, it has gone unrecognized in its early stages by the cadre of vocal—but not necessarily accurate—economists that sit by their screens watching the markets. Those who are willing to step back and put things in their proper perspective, however, can see that the glass is not half empty, but half full and getting fuller all the time. These are the people who will be prepared to take best advantage of the new business environment now unfolding. ■

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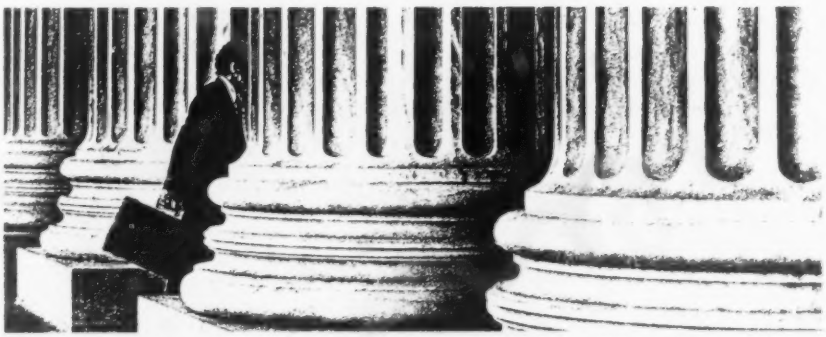
Strength



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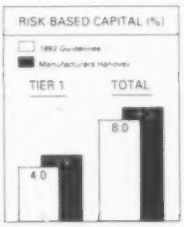

Using capital to measure the strength of a financial institution is hardly a new practice at Manufacturers Hanover. And while exceeding the new standards may be noteworthy, our aim is to continue building upon the sturdy financial foundation we already have in place.

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